

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER:KYT:NAS:TL-N-2735-99
HPLevine, ID# 62-09574

date:

SEP 17 1999

to: Chief, Examination Division, Kentucky-Tennessee District
Attention: Revenue Agent Bob Pointer

from: District Counsel, Kentucky-Tennessee District, Nashville

subject:

Follow-up opinion on tax consequences of asset transfer to LLC

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ISSUE:

1. Does the taxpayer receive a tax basis of \$ [REDACTED] from the transfer of its assets and liabilities to a limited liability company?

CONCLUSION:

1. The taxpayer will not receive a tax basis of \$ [REDACTED] or otherwise unless it remained personally liable on the liabilities assumed by the limited liability company.

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FACTS AND DISCUSSION:

[REDACTED] (hereinafter Inc.) was an S corporation which was incorporated in [REDACTED]. In [REDACTED] it transferred all of its assets and liabilities in exchange for a [REDACTED] % interest in a newly formed limited liability company, [REDACTED] (hereinafter LLC). Inc. remained in existence and became a member in the LLC. Inc. had an accumulated adjustments account (AAA) in the amount of a negative \$[REDACTED]. In the footnotes to the certified audit, the accounting firm indicated that the LLC elected to be taxed for federal income tax purposes as a partnership, and that Inc. had deferred the gain from the transfer of the net liabilities of \$[REDACTED] "because of the relationship of the parties involved and their continuing ownership of the LLC." The deferred gain was reflected as a liability on Inc's balance sheet and was used to balance the accounts and offset the negative retained earnings. The total assets were reflected at \$[REDACTED] of which \$[REDACTED] represented the amount of the investment in the LLC.

By memorandum dated May 20, 1999, we concluded that the taxpayer was required to recognize income from the transfer since the liabilities were in excess of the adjusted basis of the assets transferred. The taxpayer disagrees and asserts that it not only does not have income, but that it also has a tax basis of \$[REDACTED] for its [REDACTED] % share of the liabilities assumed by the LLC. The taxpayer's argument is incorrect *unless* it remained personally liable for the liabilities that were assumed by LLC.

The LLC has elected to be taxed as a partnership. The taxpayer has indicated that it is entitled to increase its basis for a proportionate share of liabilities assumed by the LLC. This is not entirely correct. The taxpayer's basis in part as a contributing partner is the adjusted basis of the property contributed. The contributed property however was subject to indebtedness and/or liabilities of the corporation which were assumed by the LLC and were in excess of the basis in the assets contributed. That forms the basis for the proposed adjustment.

Under Treas. Reg. § 1.752-1(d)(1), the taxpayer would be allowed to increase its basis for a proportionate share of a partnership assumption of liability only if it was personally obligated to pay the liability. See also Treas. Reg. § 1.752-2(a), (b). Although the LLC elected to be taxed as a partnership, the individual members of the LLC are not personally liable for the LLC debts. The example in Treas. Reg. § 1.752-1(g) is illustrative. In the example, the partner contributed property subject to a liability, which was not assumed by the partnership. The partner therefore remained personally liable. None of the other partners were personally liable or had any economic risk. Even though the partnership did not assume the liability, under I.R.C. § 752(c), the liability is considered to be that of the transferee partnership. The contributing partner's basis is therefore decreased since the liability was deemed to have been assumed by the transferee. The basis is also increased since the contributing partner remained liable for the liability. The other partners were not entitled to basis increases since they were not personally liable.

That the contributing partner remained personally liable for the partnership liabilities forms the critical distinction in this case. The taxpayer's [REDACTED] analysis and reliance on Treas. Reg. § 1.722-1 assumes: (1) that the contributing partner remained personally liable on the assumed partnership liability; or (2) that the partner was a general partner with personal liability for the partnership liabilities.¹ In this regard, the taxpayer does not state and it is not clear if the taxpayer is alleging that it received a basis increase from personal liability that it has with respect to the liabilities assumed by the LLC.

In this case, the individual members are not personally liable for the LLC liabilities. Limited liability is the primary benefit of the limited liability corporation as a governing entity. Although the taxpayer elected to be taxed as a partnership, it is not a partnership for liability purposes, and under State law, the members are not liable for the liabilities

¹ In the example, the other partners were liable for 80% of the contributing partner's liabilities which were assumed by the partnership and the contributing partner was liable for 20% as represented by his interest. The personal liability as a 20% general partner was the reason that the taxpayer in the example received a basis adjustment of 20% of the assumed debt.

that were assumed.² Therefore, the taxpayer cannot increase its basis for liabilities assumed by the LLC unless it also had personal liability for the LLC liabilities.

For purposes of this and our earlier analysis, we presumed that Inc. was no longer personally liable when the LLC assumed the liabilities. To the extent that Inc. remained personally liable, then it would be entitled to a basis increase for the amount that it remained personally liable for. See Smith v. Commissioner, 84 T.C. 889 (1985) (partner who assumed the liability on partnership nonrecourse debt entitled to basis increase under I.R.C. § 752(a)). See also Dakotah Hills Offices Limited Partnership v. Commissioner, T.C. Memo. 1998-134; Goodman v. Commissioner, T.C. Memo. 1990-114 and Treas. Reg. § 1.752-1(a)(2). Therefore, we suggest that you review the LLC-Inc. asset contribution and assumption of liability agreement and make such further taxpayer and third-party contacts as are necessary to determine the extent that the taxpayer remained personally liable, whether primary or secondary, on liabilities assumed by the LLC.

Even if Inc. remained personally liable and was entitled to increase its basis, each payment on the liabilities by LLC would be considered a distribution to Inc. resulting in a reduction of basis. I.R.C. § 752(b); Smith v. Commissioner, *supra*. Therefore, the income adjustment will be merely deferred in that instance.

We note that the taxpayer reduced the deficit in retained earnings by \$ [REDACTED], which appear to be based on a worksheet entitled "Cumulative [sic] Timing Differences: DR/CR)." You may want to determine the effect if any that this has on the adjustment that you propose.

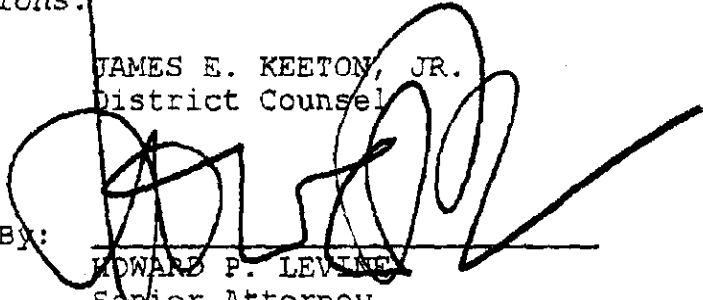
We are seeking post-review from our National Office because of the technical nature of this issue. In the interim, we suggest that you prepare in draft the proposed adjustment with the included additional grounds for disallowance in order to better facilitate discussion with the taxpayer and its representatives. We also suggest that you issue an IDR seeking the information suggested concerning the extent that Inc. remained personally liable after the assumption by LLC.

² In matters of member liability, LLCs are treated more like corporations than partnerships. Barbieri v. Swing-N-Slide Corp., 1997 Del. Ch. LEXIS 9 (Ct. Chancery 1997); 6 Del. C. § 18-303.

Attached is a client survey which we request that you consider completing. The client survey is an attempt to measure your satisfaction with the service provided by this office. We expect to be able to use your response to improve the services that we provide to you. Please contact the undersigned at (615) 250-5072 if you have any questions.

JAMES E. KEETON, JR.
District Counsel

By:


HOWARD P. LEVINE
Senior Attorney